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CREATING AN ENABLING POLICY ENVIRONMENT FOR PROMOTION OF SMALL ENTERPRISES: TRADITIONAL AND INNOVATIVE APPROACHES

by

Albert Berry[1]

Centre for International Studies
170 Bloor Street West
Suite 500
Toronto, Ontario
M5S 1T9
(416) 978-3350

[1] Department of Economics, University of Toronto, 150 St. George Street, Toronto, Ontario M5S 1A1.

CREATING AN ENABLING POLICY ENVIRONMENT FOR PROMOTION OF SMALL ENTERPRISES: TRADITIONAL AND INNOVATIVE APPROACHES

1. Introduction

The task of creating an enabling policy environment for small enterprises (SE) has been and remains a daunting one.[1] The term "enabling" is appropriate, since when small enterprise successfully contributes to a good overall economic performance in a country it must usually supply nearly all of the effort, skills and dynamism itself; neither policy nor direct support can substitute on any large scale for whatever weaknesses and limitations smaller firms may have, in part because policy makers usually have difficulty interacting effectively with such enterprise, and in part because the sector is so large that it is implausible to think that public agencies could provide much of the needed resources and skills. The main ingredient of a good policy support for small enterprise is therefore the creation of a fostering environment, which provides the right incentives for small firms, together with enough positive support and protection (e.g. against unfair practices of larger competitors) to allow such firms to make the best of their potential. Many factors conspire to make this task difficult; it is useful to mention some of these, since they provide relevant background for the subsequent discussion of the evolution of policy away from more traditional approaches and towards other, hopefully more successful ones. They include:

(i) the limited knowledge and understanding by policy makers and implementers of small enterprise, of its typical behaviour patterns and of its interface with the economic environment. The fact that small enterprises are numerous and diverse (ranging from traditional to relatively modern, belonging to different industries, having widely differing relationships with larger enterprise) makes direct familiarity with much of the sector unlikely. In most countries the number of serious studies of small enterprise and the amount of ex-post analysis of the impact on them of the economic environment and the policies pursued is very limited, such that the policy maker cannot draw too much from this source either. One specific but very important problem lies in the fact that most people who are knowledgeable about some aspects of small enterprises and their performance focus at the micro level. But understanding what makes an individual small firm successful is not the same as understanding what makes the small enterprise sector successful. Few people have focused on the second, undoubtedly more important question.

(ii) lack of political and policy voice for small enterprise. Most governments are dominated by a combination of political interests representing large enterprise, sets of technicians with more knowledge about other sectors of the economy than small enterprise, and by organized labour and sometimes other groups. Small enterprise is seldom organized in such a way as to have much involvement or influence on public policy-making. Business associations, whether

[1] We include in this term both microenterprise and small and medium enterprise (SME) with say up to 50 or 100 workers.

organized by industry or more broadly, tend to be dominated by large firms and to represent primarily the interests of those firms. Small enterprise associations often have trouble achieving the strength needed to get much influence. Contributing to the difficulty of effective organization is the incomplete mutuality of interest between microenterprise and small and medium enterprise (SME).

(iii) the above mentioned lack of either interest or knowledge/expertise by policy makers contributes to a lack of attention to small enterprise. When interest *is* there, it is often misplaced due to the lack of knowledge; much of the assistance directed to microenterprise has been based on the paternalistic assumption that such units are seldom economically efficient, and are hence more appropriately the object of social than of economic policy. This simplistic view[2] tends not to be held by the experts and students of the area, but they often have limited influence on policy. The present wave of anti-intervention thinking among economic policy-makers, whatever its general validity, may create problems for the design of good small enterprise policy since there *are* important arguments for intervention in support of this sector. Though one of the most important elements of a supportive enabling environment is well-functioning output and input markets, attaining such markets sometimes involves important but difficult types of intervention or involvement by the state. Finally, in many developing countries the macroeconomic crises of the last years have drained policy attention away from most other issues, including the small enterprise sector. The complex issues surrounding the sector mean that what is needed is a stable and knowledgeable approach, a far cry from the normal one.

(iv) small enterprise does appear to need special treatment in various ways and it is important that its needs be taken into account, not just or perhaps not even primarily in terms of sector-specific policy designed to assist it but also in the areas of financial markets, the exchange rate, trade policy, labour market policy, environment policy and many others.

Important aspects of the current economic and policy context in many countries are the presence of serious adjustment problems and/or the current or recent implementation of a series of economic reforms, among which a shift towards freer trade is a prominent component. Possibly related to these factors is the widespread tendency to increasing income inequality in many developing (and developed) countries. This trend highlights the importance of successful growth in the small enterprise sector, since in most countries the bulk of employment is found there, and the amount of productive employment which it generates is closely tied to the alleviation of poverty in the country. It is probably not an accident that the Third World market economies with the lowest levels of income inequality are also ones in which small enterprises have played an important role, as with Taiwan over a long period and Korea since the mid-1970s. It is possible that part of the negative distributional impact which seems to have accompanied the trade liberalization has been related to difficulties in the small enterprise sector in adjusting quickly to the new level of competition with imports or in export markets.

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[2] A view which owes much to the erroneous tendency to equate efficiency with high labour productivity, use of modern technology and the like. Most careful studies find that much of the small scale sector is reasonably efficient when efficiency is measured properly (Liedholm and Mead, 1987).

The trend towards globalization and freer trade creates both challenges and opportunities for small enterprise and for policy designed to maximize its contribution to social and economic welfare. Freer markets put some types of small enterprise in jeopardy, and should no doubt be complemented by short-run or longer run support policies to help some of these enterprises through the transition period. In countries where disinclination to intervention and/or incapacity to do it effectively precludes such policies, the sector may be seriously affected and the health of the economy along with it. But where this is not the case, or where small enterprise is generally less vulnerable, the push towards more market-oriented policies may create more opportunities than it does threats.

2. Broad Factors Facilitating the Creation and Health of Small Enterprises

Identifying the set of factors which facilitate creation and successful development of small enterprise is the starting point for an effective support policy. Any list is somewhat arbitrary, but one useful categorization involves distinguishing (i) availability of entrepreneurial skills; (ii) timely access to the factors of production (labour, capital, technology, etc.) and to product markets; and (iii) protection from unfair practices on the part of other firms (market discrimination, harassment, etc.).

Optimal policy in each of the three areas depends, among other things, on the state of affairs in the other areas. Thus, if entrepreneurial talent is very widespread, it will be less important to have the favourable input and output market conditions which make the entrepreneur's task easier, diminish the risks involved, etc.

Public policy is likely to be important in each of the three categories cited. In the past, most of the conscious small enterprise policy has focused in the second, and with the particular modality of direct state involvement, as in state development banks, public sector technical assistance, etc. More than complementing the activities of private firms in, say, the financial and technical assistance areas, these have involved substituting for what was felt to be the inadequate performance of these latter.

In general the character of the support for small enterprise, probably both for microenterprise and for SME, has gradually shifted towards policies with a lighter touch, policies which rely more on complementing the market than replacing it, and, hopefully, ones which reflect a better understanding of the characteristics and *modus operandi* of small firms and of markets. Yet it must be confessed that in none of these areas are we yet very far advanced; though understanding of how various types of more general economic policy affect smaller enterprise has advanced, there is often little recognition or action on this front. In many countries there is a special small enterprise policy, rather than a consideration of small enterprise needs in the framing of all aspects of economic policy.

Well-functioning markets (related to points (ii) and (iii) above) are very important to many smaller enterprises for two main reasons. First, such firms find it hard to undertake as much of a total production process as do larger firms. Managing the whole process is hard productive small firms in a given industry may not be created or may not survive. When this is the case, the health of small firms in any given industry will tend to be positively related to the prevalence of small firms in the related industries. When an economy has many small and medium firms in a number of industries, then it is easier for others to get a start and do well.

The best environment for small enterprise is probably one in which the markets relevant for them function well on their own, without public sector intervention. A major puzzle for policy in this area, however, is whether considerable direct support of some traditional types (subsidized credit and the like) is advisable when, as is normally the case, such markets are far from this ideal state. The complementing provided by vigorous small-scale input and service suppliers cannot be reproduced by any feasible government involvement, but it may nonetheless be useful. It is hard to assess relative merits of different approaches in this difficult world of the "second best".

Government Attitude to Small Firms

A government which is serious about reaping the benefits of a healthy small enterprise sector requires both a professional understanding of the role of such firms, including the absence of paternalistic attitudes, feelings that whatever is done for such firms is done in the name of social policy rather than with economic objectives, and so on. It also requires a strong cadre of support/regulatory workers, relatively well paid, having some degree of prestige, adequately prepared, etc. The details of how to organize such support/regulation systems and the options seriously available in different types of countries will vary. In some cases the only approach may be a semi-private one, whereby the government farms out the functions which need to be performed. In any case, there is an immense gap in the quality of such systems across countries. It is important to consider simultaneously the whole government apparatus which affects and partially defines the economic environment of smaller firms. In some cases the relevant apparatus is essentially exploitative, as where a large amount of bureaucratic red tape is the vehicle whereby rent-seeking officials attempt to extract money from firms. Clearly it is important to avoid the presence of nonsense red-tape since it helps to bring into existence such an exploitative public sector worker. Obviously, it is important to monitor the presence of such exploiters. At the other end of the spectrum is the essentially positive public servant, who approaches the small enterprise as an entity to be assisted where possible. Such a servant must of course understand the logic of certain controls, so that he/she does not try to help the firm to avoid them but to deal with them in the cost minimizing way. Most countries have substantial elements of both the exploitative and the supportive together with other shades of grey in between. In most cases however, both the amount of resources funnelled into such support and the quality of the workers accurately reflects a lack of government recognition of the potential importance of this sector and the related lack of dedication to helping it and setting a healthy environment.

A complicating feature with respect to the role of public policy lies in the danger of the public sector itself becoming the monopolist in the provision of a particular service. The costs of such an outcome are similar in part to those when a private sector monopoly damages the when a variety of skills and resources are needed and when some stages of production are characterized by significant economies of scale; in such cases economic logic suggests that many small firms would specialize in just one or a few stages of the total process, in which case their fate becomes dependent on how well a variety of input markets serve their needs--the coordination function demanded of the market is bigger in that case. Second, small firms are more vulnerable to the use of market power than are larger rivals, and hence more dependent on some set of controls (institutional, legal, moral, or whatever) to keep the misuse of power within bounds. To date most policy directed towards supporting small enterprise has involved direct intervention or involvement by the state--in credit programs, technical assistance, and so on. An element of the challenge at present is to find ways which involve making private markets work better rather than replacing them. Although the trend is generally in this direction at present, this is a much more subtle task, and hence one about which it is hard to feel much confidence of success in the short run. Many of the contributors to the shift of economic policy towards the market and away from state involvement are not inclined to contribute ideas and support for the "light touch" approach, some feeling that it is risky to accept any sort of intervention in the market.

When markets do work effectively they facilitate and take advantage of the complementarities across different firms and types of firms, as in the case of subcontracting. When they function badly they fail in this positive function while permitting the sort of malfunctioning mentioned in point (iii) above.

Given both their small size and scope and their related vulnerability to outside forces, the health of many small firms depends on the existence of a symbiotic relationship with other firms. One such type of symbiosis is with large firms, usually via subcontracting. The extent to which this phenomenon can contribute to the number and the productivity of smaller firms, with associated high level of employment creation, is well exemplified by the case of Japan and some other countries of Southeast Asia. Its merits have led other countries to try to emulate this success by trying to induce and facilitate large-small interactions; in most cases the results have thus far been modest at best. At the other end of the spectrum is a different type of symbiosis--that among small firms themselves, sometimes in the same activity and sometimes in complementary activities. Considerable attention has been focused recently on the externalities among groups of small firms engaged in the same activity (e.g. small exporters in manufacturing and agriculture);[3] the group can provide economies of scale in certain functions for which the individual firms are too small to do so, while leaving independence to each firm in its other functions. Another form of symbiosis is among small firms engaged in different but activities which trade with each other. A major impediment to the health of some small firms is that large suppliers and buyers do not want to deal with them, either because they simply prefer buying and selling in bulk or because the information costs of dealing with many firms are too high. Large firms in one business tend to deal with large firms in other businesses and small ones with small ones. If there are few or no small scale input suppliers and output buyers, potentially

[3] Relevant studies are those of Klein (1995) and Rhee (1990).

interests of small enterprise. But where the public sector is less efficient than the private one the costs are higher. And it is obviously difficult for governments to control the impulse of their own institutions to strive for and maintain monopoly positions; asking the government to throw public agencies into competitive situations in which they may look bad is asking a lot--not necessarily impossible but obviously not easy or feasible under all circumstances.

Some of the elements of small enterprise policy and its evolution towards new approaches are summarized in Diagram 1. It should be noted that some trends in the composition of that policy and in how it is effected are the result of increased understanding of the sector's needs, others of changes in the objective situation, e.g. the sort which make it possible to complement market forces because those forces are working more effectively. It should also be noted that much policy in this area is *de facto* experimental; it remains to be seen how well it will work out.

Diagram 1: TRENDS IN SMALL ENTERPRISE POLICY

Changes in the Mechanisms and Approaches of Small Enterprise Policy	**Policy Areas**
1. More market-complementing rather than market-substituting 2. More indirect, designed to induce certain types of market behaviour 3. More professional (informed); positive (less paternalistic, harassing, corrupt) 4. More involvement of local governments and less of national government; more of NGOs/ industry associations/universities, etc. 5. More through general economic policies and less through sectoral policy	1. Entrepreneurial development, 2. Credit 3. Technology/technical assistance 4. Labour market 5. Used machinery 6. Foreign exchange/exchange rate 7. Product markets 8. Links with large firms 9. Assistance in exporting 10. Infrastructure 11. Macroeconomic policy (monetary/fiscal/trade) 12. Environmental policy

3. Trends and Innovations in the Processes of Decision-Making and Regulation

Weaknesses in terms of the content of past policy for smaller enterprises have been partly a result of the process of decision-making, who has voice, etc., as well as the simple lack of information on some issues. A high degree of centralization, together with a lack of effective consultation/interaction with relevant parties who might be useful, has probably been responsible for much of the disinformation about the sector and its functioning. A number of countries have been undertaking a desirable shift away from such a pattern towards one which increases the involvement in policy making and execution of one or more of: local government, business associations, and small entrepreneurs themselves. The design of courses for small entrepreneurs and their workers, of technical assistance systems, and sometimes of credit systems can all benefit from the involvement of these groups.

Several general considerations, and evidence from a number of countries, point to a potentially valuable role for local government, which when it is endowed with a reasonable level of overall capacity may handle some aspects of policy-making, operations and liaising with small enterprise better than could the national government (Storper, 1991). Industrial policy at the local level appears to be coming into its own, as decentralization proceeds, along a variety of paths, in developing countries. A decent local government knows local conditions and needs better than the national government, as often interacts more easily and effectively with local business; small enterprises often have more economic weight in a given region than in the nation, and are thus accorded greater consideration. One interpretation of the impressive performance of Italian small enterprise (e.g. in international markets) is the effective interface between municipal government (with a long and special involvement in the local economy) and small business. Some recent experiments in Argentina are also promising along these lines (Gatto, 1992). Four local centres for SME are being established to foster a demand and supply for SME-related services; the government will lend financial support in the first four years with the expectation that the centres would then be self-financing.

The importance of involvement by business associations lies in their direct knowledge of the needs of their affiliates, and in the fact that the responsibility of an active role in influencing public policy may have the added benefit of increasing contacts among smaller enterprises, leading to collective action on other fronts and to information benefits: contact with other SME and with larger firms in the same sector is an important source of information for many SME.

Even for types of decisions which do or must stay lodged in the public sector, the development of effective means of consultation with the private sector is essential. In dealing with public sectors which while not totally inept suffer from limited responsiveness and other weaknesses, the input from the private sector can raise the quality of programs, keep them relevant and, over the course of time, increase the mutual respect between business and government which is a prerequisite for certain types of policies and interactions to pay off to the maximum. There are now many examples of small business organizations working with government. But it is a permanent struggle for them to achieve much voice, especially if they operate in the same sector as large firms. This is partly a matter of a country's social and political evolution. In Indonesia, for example, it is still difficult for small enterprise to organize on its own, whereas in many countries of Latin America this is now taking place.

Curbing Red Tape

There is no doubt that much government regulation in many countries has not only not had a positive function but has been damaging to such groups as small enterprise, both because it used public resource to no positive effect, creates costs for small firms and leads to bribery and corruption in the public sector. A recent World Bank study designed to quantify the costs to small exporters of some of the red tape suggests that the costs have been substantial.

It remains to be seen how much small enterprise dynamism can be unleashed by ending pernicious regulation. No doubt it will be much less than optimists (on this count) like de Soto (1986) expect since small enterprises evade much of the red tape, and since rational rent-seeking public officials do not normally exploit their victims to the point of causing them to fail.

4. Policy Trends and Innovative Approaches in Specific Policy Areas

In this section we comment on some of the policy areas relevant to the success of small enterprise, and on the evolution of approaches within those areas including newer and innovative ones.

4.1. Entrepreneurship

Clearly the success of small enterprise starts with a *strong supply of entrepreneurial talent*. It is not an accident that two of the great performers in terms of growth, Taiwan and Hong Kong, have been characterized both by the dominance of smaller establishments in the industrial structure and, underlying this, by an impressive supply of entrepreneurial talent. The quality of management/entrepreneurship has emerged as the most important determinant of the economic performance of SE in a number of microeconomic studies (Bruch and Hiemenz, 1984, 100), and management weaknesses have been fingered as the primary cause of failure among SE in the Philippines (Itao, 1980). The issue here is how policy can help to strengthen the entrepreneurial capacities of the country, complement those capacities as well as possible, and partially substitute for them when they are not strong.

With most entrepreneurs having serious deficiencies in one or another aspect of business management, and with markets and contexts changing faster than before, there is a major challenge to upgrade the skills of a large number of entrepreneurs quickly. Most entrepreneurs in SMEs do not have university backgrounds (many are former workers); only a few microentrepreneurs do. It is clear that various types of education and training pay off in greater entrepreneurial capacities, though it is always important to remember that all such education/training must complement basic entrepreneurial skills, some of which may be innate and others learned on the job. Recent surveys in several countries, including Colombia and Indonesia (Levy et al, 1994), report that the prevalence of university trained entrepreneurs is much higher for exporting SMEs than for SMEs as a whole, a fact which warrants both attention and study.

The countries which seem to have put most emphasis on training of entrepreneurs are those where the government sees a special need to foster the entrepreneurial proclivities and capacity of a particular group, as in Malaysia and Indonesia where preparatory courses are given to introduce nationals (Malays/bumiputra and Indonesians/pribumi respectively) to business activities. Clapham (1985, 133) sees preparatory courses as the responsibility of state institutions, whereas basic courses for already active entrepreneurs can usefully be provided by both public and private sector institutions. He notes that many small management institutes and private business schools have been set up in Malaysia and Indonesia and that there is a ready market for their services (ibid, 135). While it is naturally difficult to gauge the benefit/cost ratio of such training activities, a lively demand bodes well.

At the university level there is increasing awareness in developing as well as developed countries that training for work in SMEs should be a part of business school and/or engineering curricula. In 1993 a new university was founded in Argentina to focus on SME. The Institute of Business at the University of the West Indies came into existence partly in response to a felt need for training which would produce effective SME entrepreneurs. Colombia has a small university dedicated to training SME entrepreneurs. In future a higher and higher share of SME and even microenterprise entrepreneurs will have university training, which makes it doubly important that part of the curriculum prepare them as well for these functions as possible. Only in a minority of countries (e.g. Korea--see Kim and Nugent, 1994) does there seem to be a strong network of professional contacts between university departments and faculty and SME, allowing SMEs access to the professional skills of university faculty via consulting arrangements, for example.

A major challenge in many countries, to which some appear to be responding in interesting ways, is that of providing the training facilities and courses needed by SMEs, microentrepreneurs and their workers. Most countries have some form of national system for industrial training, but in many it *de facto* if not *de jure* directed its attentions to the needs to larger enterprise in the early stages of ISI industrialization. Re-orienting such entities to make them useful to small enterprise, which cannot necessarily articulate its needs as clearly, and whose needs may change rather quickly over time, is a real challenge for such institutions.

The role of NGOs, often affiliated with larger firms, in entrepreneurship training for microenterprise has been especially important and promising. The challenge of replicating and multiplying such efforts remains a large one, however.

4.2 Credit

Probably the main policy tool traditionally directed at the support of small enterprise has been credit. In the case of SME the attempt to improve access has been a combination of trying to encourage or force formal sector institutions (commercial banks, etc.) to reach down to this size range and of creating special state institutions to do so. Most of the countries which have founded public-sector institutions to provide credit to small firms in manufacturing and sometimes other sectors (Bruch and Hiemenz, Chap.6) do so at lower than market interest rates, tolerate higher levels of arrears and non-repayment, and generally make it easier for the borrower than private banks would. Both efforts have met with at best mixed success, though the lack of serious *ex post* evaluations precludes saying anything very definitive in this area.[4] For microenterprise, it has been attempts to design and implement quite different institutional arrangements (e.g. the Grameen Bank, rotating savings and loan associations, etc.) which have received most of the attention. And here too there is a notable lack of solid evaluations so our understanding of what works and how well remains limited.[5] A good credit system must walk the line between too little or too unattractive access for small firms and too much and/or too favourable conditions. It is an element of conventional wisdom among many people in close touch with smaller enterprise that their felt need for better credit access is not a good measure of how much credit could productively be allocated to them; many SE believe that lack of credit is the source of problems whose roots in fact lie elsewhere, e.g. managerial or marketing problems (Harper, 1984, 45). Some firms tend to be overoptimistic through lack of experience in business; for them it is appropriate to use own funds in the first stage of business development. Evidence has shown that many firms can get established with the very small amounts of capital that they can scrape up from their own savings and from family and friends (Clapham, 1985, 28; Lim, 1977, 22). Some firms are understandably desirous of credit when it is so subsidized as to provide a profit regardless of how productively it is used. Where real interest rates have been very negative this situation has arisen with some frequency.

While few students of small enterprise would argue that inadequate access to credit is not a problem at all, the increased information on the sector has both refined and narrowed the role which such access would be expected to play. The problems of making cheap credit very widely available to any SE which wants it are now more widely recognized. Profit-making financial institutions cannot easily provide a large flow of credit in small loans to firms with no track records and no collateral (Levitsky, 1986, 20-21). Public sector establishments may be able to do this but may lose a lot of money in the process and unless stringent in their demands for repayment may contribute to a lax attitude towards repayment on the part of the borrowers. The general consensus now seems to be that a very low interest rate is not of great importance to SE

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[4] Thus a recent World Bank review (1991, 77) concludes that its SME lending programs in a groups of five countries have varied from basically successful to substantially less so. It accepts that much in this area is still experimental.

[5] The most ambitious attempt to assess the impact of a credit program for SE, to the best of our knowledge, is that carried out by Bolnick and Nelson (1990) for Indonesia's KIK/KMKP program. Using a control group of non-borrowers they attempted to measure the impact of the credits on employment, incomes and output in the borrowing enterprises. If the subsectors and regions included were representative, the U.S. $228 million credit approvals in 1980 would have led to U.S. $73.7 million in additional fixed investment, 67,000 new jobs (at $1,100 per job) and an increase in annual value added of U.S. $46.6 million for a marginal output-capital ratio of 0.63 and a marginal output/credit ratio of 0.20.

when it does borrow from the formal financial sector, though this conclusion may be valid only when the loan is for a short period.

One of the problems in extending the formal financial system's services successfully to smaller enterprises lies in the fact that, in developing countries at least, most such systems appear to be high cost and relatively inefficient, presumably a legacy of their oligopolistic or monopolistic structure. (At the same time there is little hope of making this sector highly competitive, since it is characterized by special features which make it both difficult and dangerous to push too far in that direction.)[6] With high profits and costly labour (paid more than in other sectors given the level of human capital) the payoff to operating in small amounts is low. The potential of financial intermediaries different from these traditional ones therefore takes on considerable importance.

Some authors have in effect argued that the informal sector financial market works well enough so that there is no need to worry much about the alleged credit impediment to the growth and performance of SE (McLeod, 1984; Yotopoulos and Floro, 1991). While such studies make it clear that the informal market can and does handle some credit needs quite effectively, they leave open the question of whether alternative systems might outperform it in aiding the creation and survival of more and healthier SE firms; only studies which test for the relationship between the financial system and the overall dimensions and performance of SE are likely to avoid the biases resulting from the exclusive focus on existing (i.e. surviving) firms. Thus the only really persuasive test of how well an informal credit market functions would require a comparison across cases in some of which "better" access to the formal financial system exists and in some of which it does not. Few if any fully persuasive studies of this sort have been done.

It is widely accepted that one of the reasons for the limited access of SE to credit from the formal financial sector is the higher cost and higher risk from the point of view of the financial institution.[7] Such cost differentials go a long way towards explaining why credit goes disproportionately to the large scale sector. Another important reason, however, is that some private and public banks have direct relationships with certain of their clients, normally large ones; they may, for example, be part of the same conglomerate. Favouritism towards the "related" companies is natural and inevitable in these cases, and its presence calls in principle for some form of intervention to "level the playing field" among potential borrowers.

The experience of the Grameen Bank in Bangladesh has demonstrated the potential of a quite unbanklike financial institution in dealing with very small businesses (Hossain, 1988) and

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[6] Note Díaz-Alejandro's (1985) trenchant critique of the simplistic idea that an end to financial repression would resolve the problems of financial intermediation in the countries of Latin America.

[7] A study of Philippine financial institutions (Saito and Villanueva, 1981) indicates that administrative costs were lower in relation to outstanding loans for large scale than for small-scale borrowers (under 0.5% vs. 3.0-4.0%) and that the default risk expenses were also much lower, so that the sum of these two categories amounted to around 6% of loan value for SE but only around 2% for large industry (ibid, 634).

has led many other countries to ask themselves whether they could replicate that success. Although rather different in character, the KUPEDES program in Indonesia (operated by the government-owned commercial Bank Rakyat) has also had quite marked success (Snodgrass and Patten, 1989). Even such absolute or relative successes, however, tend to add to the view that not just any institution can make significant contributions to the performance of SE through the provision of credit. The success of the Grameen Bank is often attributed to the very special qualities of its founder, while Snodgrass and Patten are at pains to emphasize the challenge of restructuring incentives for managers in such a way that the organization would operate less like a bureaucracy and more like a business responding to market signals. In 1992 a group of private investors founded a full-fledged bank for microenterprises in Bolivia, the Banco Solidario ("Bancosol"), which today offers a range of savings schemes for small customers, has over 60,000 customers and a portfolio of U.S. $40 million. With average loans of about U.S.$ 500, it has been able to make a profit (FUNDES, 1995, 2). The 1980s saw the birth of numerous private organizations supplying credit and other financial services to microenterprise and other small producers, the majority supported and financed from the outside. It is increasingly recognized that to be sustainable, "financial institutes which serve the needs of the small customer and aim to have a palpable effect on the national economy must first cover their costs and be profit-oriented themselves." (FUNDES, 1995, 2). As this and other lessons are learned, there is increasing hope that financial systems will be less biased against SE than in the past.

Less frequently discussed than credit needs is the potential payoff to the existence of a source of venture capital for small and medium sized firms. Scitovsky has, however, made the interesting argument that the government's creation of such a fund in Taiwan contributed significantly to the successful growth of SE in that country (Scitovsky, 1985).

4.3 Technical and Managerial Assistance[8]

Apart from the shortage of financial resources, the other broad category of possible SE needs is assistance of some sort to run the business better. It may be training in managerial skills, marketing, accounting, planning or other techniques, help with technical problems, etc. It has often been noted that many small scale entrepreneurs are good at one part of the business, perhaps production or sales, but not at others. This is hardly surprising; the special feature of the small firm is that one person is often responsible for a range of quite different activities, activities which would be handled by specialists in larger firms. With time it has been increasingly recognized that some diagnoses in these areas have been too simple, e.g. the idea that the sort of bookkeeping and accounting which would be considered *de rigueur* in large firms is essential in all small ones (Harper, 1984, 68-69). It is clear, though, that many small firms have problems which could be at least in part alleviated by an effective technical/managerial assistance program. But, as with credit, it has proven difficult to develop such programs. When they are lodged in the public sector they must often overcome weak staffing and lack of incentive to have a good chance of success. When in the private sector they are typically too

[8] This section draws extensively on Berry and Mazumdar (1991).

expensive to be of much relevance to the very small and small firms, though they can be for those in the medium size range.

Raising the productivity of SE can be achieved both by the development of more productive technologies which do not require large scale and by improved utilization of the technologies already available. While some technologies used by SE are quite competitive, others would need to be improved to be or to remain competitive. Most R&D expenditures in developing countries are concentrated on large scale technologies (Stewart, 1990; Crane, 1977). While the need for appropriate intermediate technology has been widely recognized and discussed (Stewart, Thomas and de Wilde, 1990), it is evident that the inability of SE itself to undertake the relevant R&D, together with the modest efforts (in both quantity and quality terms) by governments, implies a possibly serious lack. The issue has received less attention in the literature on impediments to/determinants of SE success than many others, partly no doubt because most of the people directly associated with SE are less inclined to think in terms of better technologies that "might have been" than of credit or other forms of assistance which appear to be much more tangible possibilities. More generally, the impact on SE of technological choice in LDC manufacturing as a whole has received little careful empirical analysis, a fact which Schmitz (1982, 439) explains in part by the fact that it would require the never-easy documentation of historical processes. Nelson's early model (Nelson, 1968) suggesting that diffusion of technology from more modern (and so normally larger) firms to those farther down the size scale certainly captured part of the story. Second hand machinery sales are central to the diffusion process, and in some countries and industries, subcontracting provides a vehicle for transfer of information from the large to the small. But in other cases, such channels may be outweighed in importance by the accumulation of small improvements which result from practice, trial and error, and practical insights of SE entrepreneurs and workers. Small firms have certainly demonstrated a good deal more innovative capacity and related increases in productivity than many observers have been inclined to predict.

Although a good number of government programs have been directed at improving technology that is relevant to SE, most have involved only very modest amounts of resources; many are perceived to have had equally modest success, though it is true that since the benefits are not easy to measure, few if any studies have seriously attempted quantitative comparison of benefits and costs. Some institutes appear to have difficulty getting the sort of feedback which is important if the research activity is to bear on the real needs of SE; the large number of products encompassed in the SE sector makes it unlikely that state-organized research could touch a very significant share of them.

Both governments and commentators have focused rather more on extension and technical assistance to SE than on R&D. In his review of services available to small-medium firms (of 15 to 150 workers) in Thailand, Marsden (1984, 235) notes that a common feature of assistance programmes to small firms in LDCs is an Industrial Service Institute which provides research, training, technological development, information, marketing and other services to the firms. Such institutes have been operating for up to 25 years in some countries, often with the support of such international organizations as the ILO, UNDP, UNIDO, and since the early 1980s, the

World Bank. Many doubts have been expressed about their cost effectiveness and about the degree to which the services are available or could be provided through existing market networks. Marsden argues that the government can best contribute by establishing a good environment and appropriate incentives and by promoting the transfer of know-how in situations where market networks are weak or absent.

Machinery suppliers also provide a variety of services to their clients (Levy et al, 1994). Given their bias to sell rather than not, such suppliers will often not be reliable guides to the selection of the best technique/machine for a given SE buyer (Baily, 1977). Here other sources of information such as trade fairs are important (Marsden, 1984; Levy et al, 1994). Training provided by machinery suppliers has the advantage over more general training in that the skills taught are the directly relevant ones and are applied immediately. When provided in the client firm the conditions are the operative ones; new recruits are trained by the firm's own skilled workers.

In general the very small firms have less access to the private sector services, so there is a strong case for the government to focus its efforts on these firms. More effort than has been typical in the past should go into the role of catalyst, attempting to bring the holders of relevant skills together with potential users; working groups to plan and supervise activities in each industry to be covered could be beneficial. Chile has been among the countries to establish a system designed to subsidize first provision of technical assistance by private sector suppliers, on the idea that subsequently the firm should be well informed enough to decide whether further assistance is worth the cost or not.

It is clear, and the Taiwanese case may be the best evidence of it, that when there are lots of entrepreneurial skills, markets work well and information flows are smooth, the private market can successfully handle a wide range of firm needs. This leaves open, however, the question of what should be done before that happy situation has been reached. Unfortunately, the same countries in which private sector capacity is still quite limited are often ones in which the same can be said of the state. Japan's record and those of Korea and Taiwan remain of great interest, however, since government involvement does appear to have played a clearly positive role.

4.4 Labour Market Conditions and Institutions

Labour market imperfections and labour legislation can either contribute to a good environment for smaller enterprise or make that environment difficult. Most of the complications in this regard relate to SME rather than to microenterprise, which tends to hire few workers, especially non-family workers. But SME creates a great deal of paid employment and, in order to deal with fluctuations in its market conditions, often requires the flexibility to increase and reduce its labour force without much restraint (Cortés et al, 1987). High minimum wages which might have only modest costs in terms of their employment effects for larger firms might be more damaging, if applied with vigour, to SME. The same goes for high payroll taxes which raise the price of labour above the amount actually received by the worker. Uncertainty with respect to how regulations may be applied is also likely to create a bigger problem for SME than for larger firms, both because they are in more vulnerable situations and because the wage share is larger for the SME firms. Some form of unemployment insurance, which may or may not be feasible in any given country, would have important advantages to SME, since shifting the costs of labour mobility from the employer to general fund would benefit them.

The SME sector is thus an important one to bear in mind in the design of labour market institutions. With labour market reforms currently being implemented in a large number of developing countries, it is important that the needs of SME be well understood.

At this time it is fair to say that too little is known about just how various elements of labour legislation or of labour market functioning more generally affect SME to allow anyone to design the ideal system from that sector's point of view. What is clear is that the needs of SME are seldom fed articulately into the pool of information on the basis of which judgements are made. It may be that the reforms underway in many countries, most of which reduce government intervention and the powers of unions, will indeed be beneficial to SME and to the economies as a whole. But this will be less because they reflect a clear understanding of what SME needs than because of luck.

At present SME tends to get treated differentially, *de facto* if not *de jure*, with regard to labour legislation, including the role of unions; SME firms have a lower profile, are harder to reach, etc. In some cases this *de facto* exclusion from part of the legislation may be as good an outcome as is likely to occur. The best system, were it not for the costs of implementation, would no doubt be one in which the elements of legislation were applied with gradually increasing intensity the larger the firm size. The risk entailed in a system where non-compliance is the norm is that it may lay the grounds for exploitation and harassment by rent-seeking public officials. And the risk of dispensing with all forms of labour protection on the grounds that it benefits SME is that the overall cost to labour may be substantial; if it turns out that the sharp increases in income concentration associated with the introduction of market-oriented economic reforms are mainly due to those in the labour market, this will come to be seen as a serious cost.

Mobility of labour from smaller to larger firms is a problem for the former. Wide wage differentials by firm size contribute to that risk for smaller firms, and are thus likely to discourage in-firm human capital formation. Yet the existence of such differentials may play a positive role also if they allow labour in larger firms to earn more while not greatly lowering the total demand for labour.

4.5 Product Markets and Trade Policy

Product markets which favour the entry and maintenance of small firms are important. Sometimes the markets which are filled by small suppliers are local in character and hence niche-like. But such niches inevitably shrink as transport and communications improve with the process of development. When this occurs most small enterprises have to base their competitiveness on high productivity or low factor prices.

Promotion of effective large firm-small firm linkages (in the form of subcontracting or otherwise) has, as noted above, generally met with only modest success. It appears that helping to lay the groundwork for such collaboration, by contributing to improved performance of smaller firms is likely to be more important than direct attempts to put the two types of firms into contact with each other, though like many other conclusions, this one must be viewed as tentative. Equally difficult is the design of effective regulations and practices which could protect smaller firms against unfair practices of more powerful ones. One of the great problems of economic management, and perhaps a largely unresolvable one, is the absence of an equivalent to "anti-trust" rules which might be applied to small firms. It is not that small firms are always the losers from the use of power outside the market; sometimes they are the winners, as when sellers squat outside registered firms which pay taxes to get the services they use. But a strong case can be made that they lose more often than they win.

The most dramatic "pro-small" policy related to product markets is the reservation of certain products for small firms, as in the case of certain textiles in India. Such policies have been controversial (Little, Mazumdar and Page, 1987); they inevitably run the risk of creating inefficiencies over time even if the technology protected is relatively efficient when the reservation is created. They may be defensible in social and economic terms under certain circumstances, but it would probably require an astute and strong government to be able to manipulate them well.

One of the criticisms of traditional import substituting (ISI) polices has been the degree to which they are designed in the interests of larger rather than smaller enterprise. To some extent this is a natural concomitant of the fact that the capital intensive industries in which larger firms typically tend to dominate need protection and are the natural industries to think of as countries push up the hierarchy of industries. To some extent it presumably comes with the fact that political power is related to size of firm. A less emphasized weakness of the protectionist regime in many countries was its bias against the importation of second-hand machinery; typically new capital equipment was given favourable tariff and quota treatment; at the extreme second hand equipment was prohibited. Given the central importance of second hand machinery to allow small enterprises to get started (Cortés et al, 1987), this policy was very pernicious. The lack of political voice by small enterprise no doubt helps to account for how such a strange policy could persist so long in some countries (e.g. Indonesia--see Berry and Escandón, 1994).

Beyond the area of trade policy, the presence of a well-functioning market for used machinery can play a major positive role. Easy importation is one factor in such success, while other conditions, including a sufficiently large domestic market and the presence of good repair skills, may also play a role (Escandón, 1982).

As markets become more open it is increasingly important to be able to survive in competition with imports and eventually to be able to export. Here there is no doubt that small firms can benefit from a good deal of assistance, and some interesting experiments have been undertaken in recent years. Export oriented countries of East Asia appear to be well in the lead in terms of the quantity and quality of support they provide to small and medium exporters.

Levy et al, (1994, 39) report that, in each of Indonesia, Japan, Korea and Colombia, private channels (buyers, traders, similar firms, subcontracting principals, etc.) are the most important sources of support for small and medium manufacturing exporters in the areas of marketing and technology. But the benefits of such private mechanisms are not available equally to all SME exporters; collective support (whether from the state or from business associations, sometimes supported by the state) were valued disproportionately by the less well-endowed though subsequently successful firms. "The record of delivery of collective technical and marketing support is a chequered one, but some promising new approaches appear to be coming to the fore. The most promising interventions are those with a "light touch": their delivery mechanisms generally are decentralized; and their goals are to support, rather than supplant, the private marketplace... [T]he overall business and incentive environment is the most important determinant of the effectiveness of marketing and technological support for SMEs. However, the results also caution against complacency, against the presumption that a liberalized market place will be sufficient to secure industrial development." (Levy et al, 1994, 39-40).

4.6 Infrastructure

As with other elements of public policy, the norm has been for small enterprise needs in the area of infrastructure to come low on government priorities. In some situations rural electrification seems to have been the key to a flourishing rural manufacturing sector. Sometimes decent road connections, whether in rural or urban areas, are pivotal.

Industrial estates were a popular element of industrial policy in many developing countries from some time past. Some were designed with SME in particular in mind. Many seem to have failed to attain their goals for lack of understanding of the hoped-for clients' economic situation. The idea that clusters of firms could provide important positive externalities was not in general wrong, but the understanding of what sorts of externalities mattered to what sorts of firms often was. Now, the cluster phenomenon is helping to clarify what is and what is not useful in this area.

5. Overview

Much has been learned about what works and what does not in the area of small enterprise policy. Policy has shifted increasingly in the direction of complementing private markets rather than trying to substitute for them, and there is much to be said for this shift. But there remains a major gap in many countries between the knowledge available and that which is applied, both in sectoral policy *per se* and in more general economic policy, where the interests and needs of small enterprise have seldom been taken into account. Rapid changes of context have also rendered some previous "knowledge" irrelevant and created new challenges. It remains to be seen whether policy in this area will be very successful over the next decade or so.

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